No. 70-52

In the Supreme Court of the United States

OCTOBER TERM, 1971

UNITED STATES OF AMERICA, PETITIONER

v.

MISSISSIPPI CHEMICAL CORPORATION, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. Respondents and *amici* rest virtually their entire case on the proposition that the tax law permits a borrower to deduct as interest the excess of the cost of an asset acquired as a condition to a loan over the "fair market value" of the asset at the time of acquisition (Br. 21-32; *Amici* Br. 3-5; 11-16). There is no such rule of law, as a simple illustration will demonstrate. Assume that a commercial bank makes a loan of $10,000 for ten years at a stated annual interest rate of eight percent, but, as is common with commercial loans, requires the borrower to maintain a compensating balance of $1,000 in its checking account throughout the term of the loan. Assume further that the "present

value" of the right to receive $1,000 in ten years is $650. The "fair market value" of the compensating balance may be approximately zero, since there may be little or no market for restricted compensating balances. Certainly it is no more than $650. But regardless of "fair market value," it is clear that the borrower may deduct only the stated interest on the loan, $800, during the first year of the loan.[1]

The borrower is not entitled to a $1,000 interest or business expense deduction (assuming the compensating balance has no "fair market value") because it has not suffered a diminution of capital, but has merely converted its capital from one form of asset into another. Nor is the borrower entitled to deduct the $350 it might have earned over the term of the loan had it been free to invest its money at the going rate of interest, rather than in a non-interest bearing checking account. The $350 is not deductible interest or business expense. It is simply income that might have been, but was not, earned. And this Court held long ago in *Hort* v. *Commissioner*, 313 U.S. 28—what could hardly be controverted if stated explicitly and directly—that failure to earn income does not give rise to a deduction from income that was earned. As the Court explained (*id.* at 32-33), "[n]othing in [the statute] * * * indicates that Congress intended to allow petitioner to reduce

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[1] The result would be the same if, instead of being required to maintain a compensating balance of $1,000, the borrower were required to purchase from the bank a non-transferable, non-interest bearing certificate of deposit. The illustration in the text therefore cannot be differentiated on the ground that the borrower did not acquire an asset as a condition to the loan.

ordinary income actually received and reported by the amount of income he failed to realize."

The issue in this case thus has nothing to do with the "fair market value" or the "present value" of Class C stock at the time of its acquisition or at any other time. Respondents are entitled to a current deduction only if they suffered a diminution of capital when they purchased Class C stock; they are not entitled to a deduction if they merely converted their capital from one form of asset into another.[2] On this issue, *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345, is controlling. It sets forth the criteria to be applied in determining whether, in a forced investment situation, the investor has suffered a diminution of capital, and holds on virtually identical facts that the investor has merely converted its capital from one form of asset into another. No more is necessary to dispose of this case.

Respondents cannot escape the conclusion that *Lincoln* controls on the ground that it did not involve "the proper allocation of a payment between two items" (*Amici* Br. 15) or "the effect of a possible discrepancy

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[2] Respondents and *amici* devote substantial portions of their briefs to a showing that Class C stock has no "fair market value," and contend that the government's failure to appeal from the determination of the district court that respondents realized no income upon the receipt of Class C stock patronage dividends is inconsistent with its position here (Br. 23-39; *Amici* Br. 16-23). But, as shown above, "fair market value" is not controlling on the issue before this Court. Nor is there any inconsistency with the government's failure to appeal on the question when patronage dividends are to be taken into income. Under the cases and regulations respondents and *amici* have cited, that question, unlike the one to be decided, turns on "fair market value."

between the amount paid by the taxpayer and the value of the asset acquired" (*Amici* Br. 16). The issue decided in *Lincoln* was the proper allocation of the taxpayer's contribution to the Secondary Reserve between the cost of current insurance and the cost of an asset. The effect of a possible discrepancy between the amount paid into the Secondary Reserve and the value of the taxpayer's interest therein was indeed considered, the taxpayer contending (Br. in Opp., No. 544, 1970 Term, p. 14) that the money it pays into that reserve is "[i]n truth and substance * * * gone in the year in which it is paid * * *." This is identical to the contention here (*Amici* Br. 7, n. 2) that when respondents purchased Class C stock they "received therefor nothing of value except the use of money."

The distinction between the position of the taxpayer in *Lincoln* and that of respondents here is, in sum, only verbal. The taxpayer in *Lincoln* argued that since what it purchased had little or no value, it was not an asset; respondents argue that although they purchased an asset, it had little or no value.[3]

2. Respondents attempt on three grounds to differentiate *Lincoln* from the present case on its facts (Br. 18-21). None of these arguments has merit.

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[3] *Amici* "willingly concede" (*Amici* Br. 3) that Class C stock constitutes a capital asset. This concession is hardly worthy of the name. Under *amici's* theory of the case, respondents are entitled to deduct currently, either as interest or as business expense, $99 of the cost of each share of Class C stock purchased ($100). Upon redemption of the purchased stock, respondents presumably would contend that they are entitled to treat the $99 gain on each share as capital gain. There is thus the potential of a tax windfall—the tradeoff of current ordinary deductions for future capital gain—despite *amici's* assurance to the contrary (*Amici* Br. 7, n. 2).

a. Respondents first maintain (Br. 18) that whereas the taxpayer's interest in the Secondary Reserve in *Lincoln* constituted an income-producing asset, the Class C stock they are required to purchase does not in substance bear a return. But the opinion in *Lincoln* itself makes clear that the interest-bearing feature of the Secondary Reserve was not critical to disposition of that case. Nor is it essential to the government's position here. As the illustration concerning the commercial bank loan shows, it is enough that Class C stock constitutes an asset, and that respondents suffered no diminution of capital in acquiring it.[4]

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[4] The return which respondents in substance earn on Class C stock demonstrates beyond question, however, that its cost cannot be properly treated as a current expense on the theory that it provides no substantial future benefit. *Amici* deny that patronage dividends are in effect issued with respect to Class C stock purchased during the year. They rely on "the undeniable fact" (*Amici* Br. 20) that the amount of a cooperative's patronage dividend would remain the same even if it were to transfer purchased stock in the year of its acquisition. But since transfers of stock may normally be made only in connection with mergers and similar transactions between cooperatives, there would appear to be little more than a theoretical possibility that a transfer of purchased stock would be effected without a contemporaneous transfer of the rights to the related patronage dividends. Moreover, given the purpose of the stock purchase requirement—to vest ownership of each bank in the hands of those who borrow from it—the date of purchase is properly considered the date of record in determining entitlement to patronage dividends. Thus, even assuming that purchased stock would be transferred without the rights to the related patronage dividends, this does not mean that purchased stock bears no return, but rather that the stock was transferred "ex-dividends." *Amici* likewise are incorrect in their assertion (*Amici* Br. 20-21) that an increase or decrease in the stock purchase requirement would not affect the amount of patronage dividends. Such a change would usually result in a similar change in the amount of such dividends, since the Bank would have more or less money to lend

b. The legal right of the taxpayer in *Lincoln* to obtain its share of the Secondary Reserve in cash by cancelling its FSLIC insurance provides no real basis for differentiating the instant case. The proof in *Lincoln* was that the taxpayer, a state-chartered savings and loan association, would be forced to go out of business if it cancelled such insurance. The Court did not brush this argument aside, as respondents would have it (Br. 19). It recognized that the taxpayer could not, as a practical matter, convert its share of the Secondary Reserve into cash and remain in business, but held nevertheless that its contributions to that reserve were not currently deductible. Moreover, federally chartered savings and loan associations, to which the decision in *Lincoln* also applies, are required by statute (12 U.S.C. 1726) to insure their depositors' accounts with FSLIC, and thus are legally barred from obtaining refund of their share of the Reserve in cash unless they go out of business. The critical point, which respondents fail to recognize, is that an investor's capital is not diminished, and he is therefore not entitled to a current deduction, merely because he is forced to make an investment and cannot liquidate it. That point is common to *Lincoln* and the present case.

c. For similar reasons, respondents' contention (Br. 20-21) that *Lincoln* is inapposite because the Board of Directors of the Bank has discretion not to redeem Class C stock when it becomes eligible for redemption

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or otherwise invest, and its income would thereby be affected. Even if the amount of patronage dividends remained unchanged, however, this would signify only that the rate of return on investment had increased or decreased, not that there was no return.

is likewise unpersuasive. So long as the investor has the opportunity to recover his original capital contribution, no portion of that contribution may be treated as interest or business expense.

The suggestion that the Board would not redeem Class C stock at all is, in any event, unwarranted. The basic purposes of the Banks for Cooperatives system are to provide credit to farm cooperatives and to allow those who borrow from a cooperative bank to own it. These purposes can be accomplished only through the orderly redemption of Class C stock. While it is possible that a cooperative bank will suffer financial reverses, and for that reason be unable to revolve its stock, this risk provides no greater basis for a deduction than it would in the case of an investment in the stock of any commercial enterprise.

Respectfully submitted.

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